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If you have questions regarding material in this issue of *Estate Planning Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor, Igor Potym *(group leader)* at (312/609-7542) or any other Vedder Price attorney with whom you have worked.

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A NEW APPROACH TO TRUST DISTRIBUTIONS

New uses for familiar techniques

Traditionally, trusts have invested in balanced portfolios providing reasonable income while at the same time conserving capital. However, recent changes in the law coupled with higher returns in the stock market have caused trustees to shift their investment focus to equities. One problem with this shift is that equities generally produce little or no current income and, as a result, current trust income may not be sufficient to achieve the purposes of the trust. An innovative solution is to use trusts with an annuity trust or unitrust feature. Similar features have been used for years in charitable trusts that benefit both individuals and charities.

What are annuity trusts and unitrusts?

An annuity trust is a trust that pays a beneficiary a fixed annual amount, first from trust income and then, if necessary, from trust principal. The fixed amount is expressed in the trust as a percentage of the initial value of the trust. For example, a 7% annuity trust funded with $500,000 would pay $35,000 per year to the beneficiary.

A unitrust pays a beneficiary an amount equal to a fixed percentage of the value of the assets of the trust, determined annually. For example, a 7% unitrust funded with $500,000 would pay $35,000 to the beneficiary the first year. However, if the value of the trust were to increase to $600,000 in the next year, the payment for that year would be $42,000. Conversely, if the value of the trust were to decrease to $400,000, the payment would be $28,000.

Why the current interest in using annuity trust and unitrust features?

In the current investment environment, the focus is on total return (income plus capital appreciation) rather than on income alone. Currently, the average dividend yield on stocks in the S&P 500 is about 1.1%. A 90-day Treasury bill pays about 6.1% and a five-year Treasury note pays about 6.4%. However, total returns on equities in recent years have been substantially higher. For example, the S&P 500 returned about 21% last year. Accordingly, many investors are moving their portfolios into equities in the belief that they will receive a higher total return over time.

However, the manner in which trusts traditionally have been designed may not be responsive to the current investment environment. Trusts often provide that a current beneficiary receives the net income of the trust. Net income generally means dividends, interest, rents and similar items of income, less certain expenses, but not capital gains. A trust beneficiary may need trust income to pay living expenses. A trust invested largely in equities may not produce sufficient income for such a beneficiary. An annuity trust or unitrust feature is more likely to provide the beneficiary with sufficient cash flow. Alternatively, the trust can provide that the beneficiary will receive the greater of the income or the annuity or unitrust amount.

When should annuity trusts or unitrusts be used?

An annuity trust or unitrust should be considered in the following situations:

1. The current beneficiary needs more cash flow for living expenses than the income produced by a conservative mix of equity and fixed income investments.

2. An annuity trust or unitrust feature can be used to avoid a potential conflict between the interests of current and future beneficiaries. A current beneficiary usually desires investments that maximize cash flow, while a future beneficiary prefers investments for capital growth. A unitrust or annuity trust feature allows the trustee to invest for growth for the future beneficiaries while providing a prescribed cash flow for the current beneficiaries. Investing for growth also may produce overall income tax savings because long-term capital gains are taxed at a maximum rate of 20% while ordinary income is taxed at a maximum rate of 39.6%.

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Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with 190 attorneys in Chicago, New York City and Livingston, New Jersey.

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For questions about using an annuity trust or unitrust, please contact any member of the estate planning group.

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3. Because a unitrust feature provides payments based on a fixed percentage of the value of the trust determined annually, it should be used when it is desirable for the current beneficiary to receive a share of future growth in the value of the trust assets. As the value of the trust increases, so do the unitrust payments. However, if the value of the trust decreases, the unitrust payments would decrease as well. To reduce the downside risk for the current beneficiary, the trust could pay the greater of trust income or the unitrust amount. To eliminate the downside risk altogether, the trust could pay the greater of a fixed annuity amount or the unitrust amount.

Annuity trust or unitrust features are innovative alternatives that can be adopted to accomplish a variety of objectives. Although not for everyone, the use of these techniques is likely to become more popular and, ultimately, may become the standard method of providing for trust distributions.

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